

Notice of Proposed Emergency Action
The California Department of Tax and Fee Administration
Has Adopted California Code of Regulations, Title 18,
Section 3700, *Cannabis Excise and Cultivation Taxes*

NOTICE IS HEREBY GIVEN that the California Department of Tax and Fee Administration (Department), pursuant to the authority vested in the Department pursuant to Revenue and Taxation Code (RTC) section 34013,¹ has adopted California Code of Regulations, title 18, section (Regulation) 3700, *Cannabis Excise and Cultivation Taxes*, as an emergency regulation in accordance with Government Code (GC) section 11346.1, to be codified in new chapter 8.7, Cannabis Tax Regulations, which is being added to division 2 of title 18 of the California Code of Regulations. Regulation 3700 implements, interprets, and makes specific RTC sections 34010, 34011, 34012, 34013, and 34015, which apply to the cannabis excise and cultivation taxes imposed by part 14.5, Cannabis Taxes, (commencing with section 34010) of division 2 of the RTC, as added by the voters' approval of Proposition 64 (Prop. 64) on November 8, 2016, and amended by Senate Bill No. (SB) 94 (Stats. 2017, ch. 27) and Assembly Bill No. (AB) 133 (Stats. 2017, ch. 253), which is commonly referred to as the Cannabis Tax Law (CTL).² Regulation 3700 also incorporates provisions from RTC section 55044, which authorizes the Department to relieve the penalty imposed by RTC section 34013, subdivision (e), under specified circumstances.

EMERGENCY

Statement of Emergency

RTC section 34013, subdivisions (a) and (b), require the Department to administer and collect the cannabis excise and cultivation taxes imposed by the CTL and authorize the Department to prescribe, adopt, and enforce regulations relating to the administration and enforcement of the cannabis taxes. RTC section 34013, subdivision (d), also authorizes the Department to prescribe, adopt, and enforce any emergency regulations that are necessary to implement, administer, and enforce its duties under the CTL. And, it provides that, for purposes of chapter 3.5 (commencing with section 11340) of part 1 of division 3 of title 2 of the GC, including section 11349.6, the adoption of such a regulation "is an emergency and shall be considered by the Office of Administrative Law as necessary for the immediate preservation of the public peace, health and safety, and general welfare."

¹ Assembly Bill No. 102 (Stats. 2017, ch. 16) established the California Department of Tax and Fee Administration and transferred the State Board of Equalization's (Board's) duties, powers and responsibilities under RTC section 34013 to administer and collect the cannabis excise and cultivation taxes to the Department, effective July 1, 2017. (Gov. Code, §§ 15570, 15570.22.)

² Pursuant to GC section 15570.24 and RTC section 20.5, the references to the Board in the CTL refer to the Department.

Section 48 Statement

GC section 11346.1, subdivision (a)(2), requires that, at least five working days prior to submission of the proposed emergency regulation to the Office of Administrative Law, the Department provide a notice of the proposed emergency action to every person who has filed a request for notice of regulatory action with the Department. After submission of the proposed emergency regulation to the Office of Administrative Law, the Office of Administrative Law shall allow interested persons five calendar days to submit comments on the proposed emergency regulation as set forth in GC section 11349.6.

AUTHORITY

RTC section 34013

REFERENCE

RTC sections 34010, 34011, 34012, 34013, 43015, and 55044

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Summary of Existing Laws and Regulations

On November 5, 1996, California voters approved Proposition 215, which added section 11362.5, the Compassionate Use Act of 1996, to the Health and Safety Code (HSC) to exempt certain patients and their primary caregivers from criminal liability under state law for the possession and cultivation of marijuana for medical purposes. In 2003, the Legislature added chapter 2.5, Medical Marijuana Program, (commencing with section 11362.7) to chapter 6 of division 10 of the HSC. (SB 420 (Stats. 2003, ch. 875).) As relevant here, the Medical Marijuana Program statutes defined certain terms, set possession guidelines for medical marijuana, recognized a qualified right to collectively or cooperatively cultivate marijuana for medical purposes, and required the Attorney General to adopt guidelines to ensure the security and non-diversion of marijuana grown for medical use, which the Attorney General released in August of 2008. (HSC, §§ 11362.7, 11362.77, 11362.775, 11362.81.)

In 2015, the Legislature added chapter 3.5 (commencing with section 19300) to division 8 of the Business and Professions Code (BPC), the Medical Marijuana Regulation and Safety Act (MMRSA), through the enactment of a package of three bills (AB 243 (Stats. 2015, ch. 688), AB 266 (Stats. 2015, ch. 689), and SB 643 (Stats. 2015, ch. 719)). As relevant here, the MMRSA established a comprehensive licensing and regulatory framework for the cultivation, manufacturing, transportation, distribution, and sale of medical marijuana and established the Bureau of Medical Marijuana Regulation in the Department of Consumer Affairs to administer the provisions of the MMRSA. Also, as relevant here, the Legislature subsequently changed the name of the MMRSA to the Medical Cannabis Regulation and Safety Act (MCRSA) and changed the name of the Bureau of Medical Marijuana Regulation to the Bureau of Medical Cannabis Regulation, effective June 27, 2016. (SB 837 (Stats. 2016, ch. 32).)

On November 8, 2016, California voters approved Prop. 64, “the Control, Regulate and Tax Adult Use of Marijuana Act (‘the Adult Use of Marijuana Act’)” (AUMA). (Prop. 64, § 1.) As relevant here, the AUMA added division 10, Marijuana, (commencing with section 26000) to the BPC to establish a comprehensive system to control and regulate the cultivation, distribution, transport, storage, manufacturing, processing, and sale of nonmedical marijuana and marijuana products, and changed the name of the Bureau of Medical Marijuana Regulation to the Bureau of Marijuana Control. The AUMA also added the CTL to the RTC to impose marijuana excise and cultivation taxes, effective January 1, 2018. (The current provisions of both taxes are discussed below.) As relevant here, the CTL as added by the AUMA, defined the terms “marijuana flowers,” “marijuana leaves,” and “microbusiness” and imposed a penalty for the failure to pay the marijuana excise and cultivation taxes “of at least one-half the amount of the taxes not paid.” (RTC, § 34013.)

In 2017, the Legislature enacted SB 94 (Stats. 2017, ch. 27). As relevant here, SB 94 repealed the MCRSA, included certain provisions from the MCRSA in division 10 of the BPC, changed the title of division 10 of the BPC to “Cannabis,” changed the name of the Bureau of Marijuana Control to the Bureau of Cannabis Control (Bureau), and named division 10 of the BPC the “Medicinal and Adult-Use Cannabis Regulation and Safety Act” (MAUCRSA). With respect to taxes, SB 94 amended the CTL to ease and streamline tax collection and remittance to the Department. As relevant here, SB 94: (1) replaced the references to “marijuana” with references to “cannabis” throughout the CTL; (2) revised the cannabis excise tax so that it is imposed upon purchasers at a rate of 15 percent of the average market price, instead of the retail selling price, and is collected by a distributor from a cannabis retailer, instead of being paid to the Department by the retailer; (3) required cannabis retailers to provide purchasers with an invoice, receipt, or other document (receipt) that separately displays the cannabis excise tax and includes a statement that reads: “The cannabis cultivation and excise taxes are included in the total amount of this invoice”; (4) revised the cannabis cultivation tax to require a distributor or a manufacturer to collect the cultivation tax from a cultivator, a manufacturer to remit any cultivation tax collected from a cultivator to a distributor, and require a distributor to remit those taxes to the Department; and (5) defined the phrase “enters the commercial market,” and the terms “cultivator,” “distributor,” and “cannabis retailer.”

Also, in 2017, the Legislature enacted AB 133 (Stats. 2017, ch. 253). As relevant here, AB 133: (1) removed the requirement that a cannabis retailer display the cannabis excise tax separately from the price of cannabis and cannabis products to consumers; (2) removed the requirement that a cannabis retailer state on the purchase invoice that the cannabis cultivation tax is included in the total amount of the invoice; and (3) authorized the Department to prescribe other means to display the cannabis excise tax on an invoice, receipt, or other document from a cannabis retailer given to the purchaser. Also, AB 133 further defined the phrase “enters the commercial market,” defined the term “manufacturer,” and amended RTC section 55044 in the Fee Collection Procedures Law (FCPL) to authorize the Department to relieve a person of the penalty imposed under RTC section 34013 of at least one-half the amount of the taxes not paid if the Department finds that the person’s failure to make a timely payment is due to reasonable cause and circumstances beyond the person’s control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect.

As a result, effective January 1, 2018, the CTL will impose a cannabis excise tax upon purchasers of cannabis or cannabis products sold in this state at the rate of 15 percent of the average market price of any retail sale by a cannabis retailer. (RTC, § 34011, subd. (a).) Also, the cannabis excise tax must be collected by and paid to a cannabis retailer, remitted by the cannabis retailer to a distributor, and then reported and paid to the Department by the distributor. (RTC, §§ 34011, subd. (b), 34015, subd. (a).)

Also, effective January 1, 2018, the CTL will impose a cultivation tax on all harvested cannabis that enters the commercial market upon all cultivators (RTC, § 34012, subd. (a)) and all cannabis removed from a cultivator's premises, except plant waste, will be presumed to be sold and thereby taxable. (RTC, § 34012, subd. (i).) The rate of the tax on cannabis flowers is nine dollars and twenty-five cents (\$9.25) per dry-weight ounce and the rate of the tax on cannabis leaves is two dollars and seventy-five cents (\$2.75) per dry-weight ounce. Also, the Department is authorized to establish other categories of harvested cannabis, categories for unprocessed or frozen cannabis or immature plants, or cannabis that is shipped directly to manufacturers, and the established categories are required to be taxed at their relative value compared with cannabis flowers. (RTC, § 34012, subds. (a) and (c)). In addition, distributors are required to collect the cultivation tax from cultivators, except that manufacturers are required to collect the cultivation tax on the first sale or transfer of unprocessed cannabis by a cultivator to a manufacturer and remit it to a distributor (RTC, § 34012, subd. (h)), and distributors are required to report and pay the tax to the Department (RTC, § 34015). The cultivation tax does not apply to cannabis cultivated for personal use under HSC section 11362.1 or cultivated by a qualified patient or primary caregiver in accordance with the Compassionate Use Act of 1996. (RTC, § 34012, subd. (j).)

Furthermore, the CTL currently provides that:

- “In an arm’s length transaction, the average market price means the average retail price determined by the wholesale cost of the cannabis or cannabis products sold or transferred to a cannabis retailer, plus a mark-up, as determined by the department on a biannual basis in six-month intervals” (RTC, § 34010, subd. (b)(1));
- “In a nonarm’s length transaction, the average market price means the cannabis retailer’s gross receipts [(as defined in RTC, § 6012)] from the retail sale of the cannabis or cannabis products” (RTC, § 34010, subd. (b)(2));
- “‘Cannabis flowers’ shall mean the dried flowers of the cannabis plant as defined by the [Department]” (RTC, § 34010, subd. (h));
- “‘Cannabis’ leaves’ shall mean all parts of the cannabis plant other than cannabis flowers that are sold or consumed” (RTC, § 34010, subd. (i));
- “‘Cultivator’ shall mean all persons required to be licensed to cultivate cannabis pursuant to [the MAUCRSA]” (RTC, § 34010, subd. (k));
- “‘Distributor’ shall mean a person required to be licensed as a distributor pursuant to [the MAUCRSA]” (RTC, § 34010, subd. (l));
- “‘Enters’ the commercial market’ shall mean cannabis or cannabis product, except for immature cannabis plants and seeds, that complete and comply with a quality assurance review and testing, as described in Section 26110 of the [BPC]” in the MAUCRSA (RTC, § 34010, subd. (m));

- “‘Manufacturer’ shall mean a person required to be licensed as a manufacturer pursuant to [the MAUCRSA]” (RTC, § 34010, subd. (v)); and
- “‘Microbusiness’ shall have the same meaning as set forth in [BPC section 26070, subdivision (a)(3),]” in the MAUCRSA. (RTC, § 34010, subd. (o)).

Effect, Objective, and Benefits of Emergency Regulation 3700

The Department initially determined that there are issues regarding the meaning of terms used in the CTL, issues regarding the imposition and collection of the cultivation tax, and an issue regarding the imposition of the penalty of at least one-half the amount of the taxes not paid that it is critical for the Department to address through the adoption of an emergency regulation before the cannabis excise and cultivation taxes are effective January 1, 2018. Therefore, the Department prepared a draft of the emergency regulation. Department staff conducted an interested parties meeting on August 2, 2017, to discuss the draft emergency regulation. Staff also accepted written comments regarding the draft emergency regulation and received written comments from a number of interested parties, including cannabis growers, distributors, manufacturers, retailers, and industry associations.

After discussing the draft emergency regulation with the interested parties and reviewing the interested parties’ written comments, the Department determined that some changes needed to be made to further refine the original draft emergency regulation. The Department also determined that there are additional issues regarding the meaning of terms used in the CTL, there are two additional issues regarding the imposition of the cultivation tax, and an additional issue regarding the reporting of the excise tax that it is critical for the Department to address through the adoption of an emergency regulation before the cannabis excise and cultivation taxes are effective January 1, 2018. Therefore, the Department revised the draft emergency regulation accordingly and adopted the final draft of emergency Regulation 3700 to have the effect and accomplish the objective of addressing all the critical issues with the CTL discussed in detail below. The Department will also continue to work with the interested parties to determine whether there are other issues with the CTL that need to be addressed through the adoption of a regulation, and the Department may amend emergency Regulation 3700 or adopt another emergency regulation if necessary.

The Department anticipates that the adoption of emergency Regulation 3700 will promote fairness and benefit cultivators, manufacturers, distributors, retailers, and the Department by addressing all of the critical issues with the CTL (discussed in detail below) and clarifying the provisions of the cannabis cultivation and excise taxes imposed by the CTL before those taxes are effective January 1, 2018.

The Department has performed an evaluation of whether emergency Regulation 3700 is inconsistent or incompatible with existing state regulations and determined that the emergency regulation is not inconsistent or incompatible with existing state regulations. This is because there are no other cannabis cultivation or excise tax regulations. In addition, the Department has determined that there are no comparable federal regulations or statutes to emergency Regulation 3700.

Regulation 3700, Subdivision (a)

The CTL provides that the term “cannabis” shall have the same meaning as set forth in HSC section 11018, which provides that the term “means all parts of the plant *Cannabis sativa* L..” The CTL also separately defines the term “cannabis flowers” to mean “the dried flowers of the cannabis plant as defined by the [Department]” and the term “cannabis leaves” to mean “all parts of the cannabis plant other than cannabis flowers that are sold or consumed.” (RTC, § 34010.) Therefore, the Department determined that it is necessary for Regulation 3700 to further define the terms cannabis flowers and cannabis leaves to clarify that they respectively refer to the flowers and other parts of the plant *Cannabis sativa* L. so that the readers of the regulation will not have to refer back to HSC section 11018. The Department also determined that it is necessary for Regulation 3700 to further define the term cannabis flowers to clarify that it refers to “harvested, dried, and cured” cannabis flowers prior to converting the plant material into a different form and clarify that flowers does not include leaves or stems.

The MAUCRSA specifically provides for the issuance of licenses to microbusinesses for the cultivation of cannabis on an area less than 10,000 square feet and to act as a licensed distributor, manufacturer, and retailer (BPC, § 26070, subd. (a)(3)(A)), and the term microbusiness has the same meaning for purposes of the CTL as it does for purposes of the MAUCRSA. (RTC, § 34010.) Also, the CTL defines the term cultivator to mean “all persons required to be licensed to cultivate cannabis pursuant to” the MAUCRSA, the term distributor to mean “a person required to be licensed as a distributor pursuant to” the MAUCRSA, and the term manufacturer to mean “a person required to be licensed as a manufacturer pursuant to” the MAUCRSA (RTC, §34010); and a microbusiness is not exempt from the MAUCRSA’s requirements to obtain a license to cultivate, manufacture, or distribute cannabis. Therefore, the Department determined that it is necessary for Regulation 3700 to further define the term cultivator to clarify that it includes a microbusiness that cultivates cannabis, the term distributor to clarify that it includes a microbusiness that acts as a licensed distributor of cannabis, and the term manufacturer to clarify that it includes a microbusiness that acts as a licensed manufacturer of cannabis products.

Currently, the CTL provides two categories of cannabis for purposes of the cultivation tax, cannabis flowers and cannabis leaves, and it expressly defines cannabis flowers to mean “dried flowers.” The Department was concerned that cultivators may sell cannabis in a form that does not clearly fall into either statutory category, including cannabis in a form which is not dry. Therefore, Department staff sought input from interested parties as to whether other categories were needed, as well as data to determine each new category’s relative value compared to cannabis flowers.

In response, the California Growers Association (CGA) submitted a written comment dated August 25, 2017, suggesting that the Department establish categories for fresh (wet) products to be taxed at the rate of ten percent of the dry-weight rate. CGA further suggests that the products be weighed within six hours of harvest in order to be eligible for the fresh rate. CGA also suggested a new category for whole plants and a composite rate for whole plants that is 30 percent flower and 70 percent leaf (rounded to \$4.75 per ounce). Weedmaps submitted a written comment dated August 16, 2017, suggesting that the Department consider a category for wet or frozen cannabis. In the comment, Weedmaps stated that the value of wet or frozen cannabis

would likely be less than value of dried cannabis flowers because they can have a moisture content of greater than 80 percent. Weedmaps further acknowledged that determining the rate for the new category would be difficult and suggested that the Colorado Department of Revenue's recently released retail excise tax "Wet Whole Plant Rate" may provide some insight. Weedmaps also expressed its opinion that immature plants and clones, as well as seeds, are not subject to the cultivation tax, but are subject to the excise tax. Also, Front Range Biosciences, Inc. (Front Range), submitted a written comment dated August 23, 2017, expressing Front Range's opinion that a new category for immature plants or clones should be established with clarification that the immature plants or clones are not subject to the cultivation tax.

The Department considered the comments, determined that there will likely be sales of fresh (harvested, but not dried) cannabis plants that will be subject to the cultivation tax. The Department also determined that it is necessary for Regulation 3700 to define the term "fresh cannabis plant" based upon Colorado's definition for the term wet whole plants (plants that are cut off just above the roots, which are not trimmed, dried, or cured, and must be weighed within 2 hours of the plant being harvested and without any further processing),³ and establish a separate cultivation tax rate for fresh cannabis plant. Therefore, Regulation 3700 defines fresh cannabis plant to mean "the flowers, leaves, or a combination of adjoined flowers, leaves, stems, and stalk from the plant *Cannabis sativa* L. that is either cut off just above the roots, or otherwise removed from the plant," which is "weighed within two hours of the plant being harvested and without any further processing." Regulation 3700 also sets the rate of the cultivation tax on fresh cannabis plant at \$1.29 per ounce based on the Department's internal research and analysis.⁴

The Department required that fresh cannabis plant be weighed within two hours of harvest, instead of six hours as suggested by CGA, because the Department understands that a considerable amount of additional drying can occur over six hours. The Department will continue to work with growers and other interested parties to establish new categories or further define the proposed fresh cannabis plant category. And, the Department agrees with Weedmaps that immature plants (including clones) and seeds are not currently subject to the cultivation tax because the tax only applies to cannabis or a cannabis product that "enters the commercial market," and the phrase "enters the commercial market" specifically excludes immature cannabis plants (including clones) and seeds. (RTC, § 34010, subd. (m).)

The Department understands that with respect to the weighing of cannabis, it may be common industry practice to agree that an ounce consists of 28 grams. However, an "ounce" is a standard measure of weight that is equal to one sixteenth of a pound and its equivalent metric unit of mass is 28.349 grams, which is equal to 28.35 grams when rounded to the nearest hundredth (28.35), as determined by the National Institute of Standards and Technology in the United States Department of Commerce. Therefore, the Department determined that it is necessary to define the term ounce to clarify whether it is equal to 28, 28.35, or 28.349 grams, and Regulation 3700 defines the term ounce so that it is clear it is equal to 28.35 grams because the Department

³ Information about Colorado's retail excise tax is available at <https://www.colorado.gov/pacific/tax/marijuana-taxes-file>.

⁴ Rate setting is exempt from the California Administrative Procedure Act's rulemaking requirements. (GC, § 11340.9.)

determined that rounding to the nearest hundredth is reasonable for purposes of imposing the cultivation tax.

The Department received a written comment dated August 15, 2017, from Boveda, Inc. (Boveda), in which Boveda expressed concern that cultivators may over-dry flowers to reduce the amount of cultivation tax owed, Boveda suggested that the Department specify the acceptable water activity level (moisture content) of dried cannabis flowers when weighed for purposes of imposing the cultivation tax, and recommend that the level be “at a Water Activity at or between .65 and .55.” However, the CTL does not establish an acceptable water activity level for dried cannabis flowers. The CTL does not require the Department to establish such a level and no other interested parties indicated that there is a need for the Department to establish such a level at this time. Also, the Department understands that the acceptable water activity levels and/or moisture content of cannabis flowers will be prescribed in the regulations promulgated by the Bureau with respect to testing cannabis. Therefore, the Department did not agree that it is necessary for the Department to specify the acceptable water activity level of dried cannabis flowers for purposes of the cultivation tax at this time.

Pursuant to RTC section 34012, subdivision (i), all cannabis removed from a cultivator’s premises, except for plant waste, is presumed to be sold and thereby taxable under section 34012’s cultivation tax. However, the term “plant waste” is not defined in the CTL. Therefore, the Department determined it was necessary to define the term “plant waste” to clarify how the presumption applies and Regulation 3700 defines plant waste consistent with definition of the term “cannabis waste” used in the California Department of Food and Agriculture’s (CDFA’s) proposed MCRSA Regulation 8305 (3 Cal. Code Regs., § 8305), which provided that “‘cannabis waste’ is waste that is not hazardous waste as defined in Section 40141 of [the] Public Resources Code, and is solid waste, as defined in Section 40191 of [the] Public Resources Code, that contains cannabis and that has been made unusable and unrecognizable . . . by grinding and incorporating the cannabis with other ground material so that the resulting mixture is at least 50 percent noncannabis material by volume.”⁵

Weedmaps’ written comment dated August 16, 2017, generally expressed agreement with the Department’s definition of plant waste mirroring the CDFA’s definition of cannabis waste. However, the comment also expressed concern with the requirement of mixing cannabis with non-cannabis material as it may not necessarily add health or safety protection and would increase the volume of plant waste, and suggested that the Department eliminate the requirement to mix the cannabis with non-cannabis material and leverage track and trace and inspections.

The CDFA concluded that the requirement of mixing cannabis with non-cannabis material is a necessary component of the definition of cannabis waste. Also, the track and trace system is not yet in place and the Department does not yet know how it will address plant waste. Therefore, the Department did not agree to eliminate the requirement of mixing cannabis with non-cannabis material from the definition of plant waste, but the Department will continue to monitor the issue raised by Weedmaps and may amend the definition if new information indicates that amendments are needed.

⁵ The CDFA withdrew proposed MCRSA Regulation 8305 after the MAUCRSA was enacted.

The cannabis excise tax is imposed at the rate of 15 percent of the average market price of any retail sale by a cannabis retailer. RTC section 34010, subdivision (b)(1), provides that “[i]n an arm’s length transaction, the average market price means the average retail price determined by the wholesale cost of the cannabis or cannabis products sold or transferred to a cannabis retailer, plus a mark-up, as determined by the [D]epartment on a biannual basis in six-month intervals.” However, the term “wholesale cost” is not defined in the CTL, and the lack of a definition may create confusion, and make it difficult for distributors to collect and retailers to pay the appropriate amount of excise tax. Therefore, the Department determined that it is necessary to define the term “wholesale cost,” and Regulation 3700 defines wholesale cost as the amount paid by the retailer for the cannabis or cannabis products, including transportation charges, and requires any discounts or trade allowances to be added back when determining wholesale cost. Regulation 3700’s definition of the wholesale cost of cannabis and cannabis products is similar to the definition of the wholesale cost of tobacco products purchased in an arm’s length transaction in Regulation 4076, subdivision (b)(1).

The Department received a written comment from Berkeley Patients Group (BPG) dated August 24, 2017, in which BPG suggested that the definition of wholesale cost exclude locally imposed taxes and distribution/transportation fees and expenses. However, all amounts paid by a cannabis retailer for cannabis or a cannabis products, such as locally imposed taxes and distribution/transportation fees and expenses, may reasonably be included in the wholesale cost of that cannabis or those cannabis products. Therefore, the Department did not change the definition of wholesale cost as suggested by BPG.

Regulation 3700, Subdivision (b)

RTC section 34012, subdivision (h)(1), requires a distributor to “collect the cultivation tax from a cultivator on all harvested cannabis that enters the commercial market,” unless the cultivator is not required to send, and does not send, the harvested cannabis to a distributor. RTC section 34010 provides that cannabis or cannabis product enters the commercial market once it completes and complies with “a quality assurance review and testing, as described in Section 26110 of the [BPC].” Also, BPC section 26070, subdivision (l), authorizes the Bureau to waive the testing requirement and allow a licensee to sell cannabis or cannabis products that have not been tested for a limited and finite time after January 1, 2018, as determined by the Bureau. And, the Department is concerned that there may be some confusion as to when a distributor is required to collect the cultivation tax when the testing requirement is waived. Therefore, the Department determined it is necessary to address the potential confusion, and Regulation 3700 clarifies that when the testing requirement is waived, “a distributor shall collect the cultivation tax from cultivators when cannabis is transferred or sold to the distributor.” The Department established the time of sale or transfer to the distributor as the time for collection of the cultivation tax when the testing requirement is waived because RTC section 34012, subdivision (h)(2), establishes the time of sale or transfer to a manufacturer as the time for collection of the same tax by a manufacturer, and the time of sale or transfer is the best time for a distributor to collect the cultivation tax from a cultivator.

Regulation 3700, Subdivision (c)

The statutory cultivation tax rates are nine dollars and twenty-five cents (\$9.25) per dry-weight ounce of cannabis flowers, and two dollars and seventy-five cents (\$2.75) per dry-weight ounce of cannabis leaves, and Regulation 3700 sets the rate of the cultivation tax on fresh cannabis plant at \$1.29 per ounce, as discussed above. However, the Department understands that there may be situations in which a cultivator sells harvested cannabis in amounts other than whole ounces, and there may be confusion as to whether the cultivation tax applies to fractions of an ounce or what the correct rate would be in such circumstances. As such, the Department determined that it is necessary to address the potential confusion, and Regulation 3700 clarifies that proportionate rates apply to quantities that are a fraction of an ounce.

Regulation 3700, Subdivision (d)

Pursuant to RTC section 34012, subdivision (i), all cannabis removed from a cultivator's premises, except for plant waste, is presumed to be sold and thereby taxable under section 34012's cultivation tax. The Department has determined that the presumption is rebuttable because there are some circumstances in which cannabis may be removed from a cultivator's premises for valid purposes other than for sale. Therefore, the Department sought input from cultivators, as well as other interested parties, to identify specific reasons, other than for sale, why cannabis might be removed from a cultivator's premises.

Several interested parties provided examples of valid reasons for cannabis to be removed from a cultivator's premises for non-sale purposes, including CFAM Managements Group, Inc., which suggested that the processing and storage of harvested cannabis are valid reasons. The Department agreed that processing and storage may be valid reasons to remove cannabis from a cultivator's premises, but the Department also noted that, to the extent that cannabis being stored has completed and complied with the required quality assurance review and testing, the cannabis has entered the commercial market and is subject to the cultivation tax. Therefore, the Department determined that it is necessary for Regulation 3700 to incorporate and duplicate portions of the presumption in RTC section 34012, subdivision (i), then clarify that the presumption "may be rebutted by a preponderance of the evidence demonstrating that the cannabis was removed for purposes other than for entry into the commercial market," and clarify that those circumstances or reasons include, but are not limited to fire, flood, pest control, processing, testing, and storage prior to the time the cannabis has completed and complied with the required quality assurance review and testing.

Regulation 3700, Subdivision (e)

As previously discussed, cannabis retailers are required to collect the cannabis excise tax from their customers and remit it to their distributors. (RTC, § 34011.) As a result, the CTL does not require a distributor to collect the cannabis excise tax due on cannabis or cannabis products at the time the cannabis or cannabis products are sold or transferred to the cannabis retailer. Instead, RTC section 34011, subdivision (b)(1), provides that:

- In an arm's length transaction between a distributor and cannabis retailer, the distributor is required to collect the cannabis excise tax from the cannabis retailer on or before 90 days after the sale or transfer of cannabis or cannabis product to the cannabis retailer; and

- In a nonarm's length transaction between a distributor and cannabis retailer, the distributor is required to collect the cannabis excise tax from the cannabis retailer on or before 90 days after the sale or transfer of cannabis or cannabis product to the cannabis retailer, or at the time of retail sale by the cannabis retailer, whichever is earlier.

Also, the CTL generally requires distributors to report and remit the cannabis excise taxes they collect from cannabis retailers to the Department quarterly on or before the last day of the month following each quarterly period of three months (RTC, § 34015, subd. (a)), but the CTL does not specify the quarterly periods for which the excise tax must be reported and remitted. So, the Department determined that there may be confusion as to whether the excise tax must be reported and paid with the quarterly return for the period in which the transfer or sale to the cannabis retailer takes place or the period when the excise tax is actually collected from the cannabis retailer, and that it is necessary for Regulation 3700 to specify the quarterly return on which the excise tax must be reported.

The Department received written comments from several interested parties on the reporting issue. Written comments sent by or on behalf of the California Cannabis Industry Association (CCIA) dated August 24, 2017, Kiva Confections dated August 24, 2017, Therapy Tonics & Provisions LLC dated August 24, 2017, International Cannabis Farmers Association dated August 25, 2017, and the Consortium Management Group/Caliva dated August 25, 2017, suggested that the excise tax be reported in the quarter following the quarter in which the distributor transfers or sells the product to the retailer. Written comments from Weedmaps dated August 16, 2017, and Pacific Expeditors, Inc., dated August 23, 2017, suggested that the excise tax be reported and paid with the quarterly return for the period in which the excise tax was collected. Also, written comments sent by or on behalf of the Oakland Distribution Company, Inc., dated August 15, 2017, and the Service Employees International Union, Local 1000, dated August 16, 2017, recommended that the distributor report the excise tax with the quarterly return in which the distributor sells or transfers the cannabis and cannabis products to the retailer.

The Department determined that distributors will be required to file sales and use tax returns reporting their sales of cannabis and cannabis products in the quarters that the sales occur, in accordance with RTC sections 6452 and 6453. For example, if a distributor sells cannabis during the first calendar quarter of 2018 (January 1 through March 31), then the sale of that cannabis will be required to be reported on the distributor's sales and use tax return for the first calendar quarter of 2018, which will be due on or before April 30, 2018 (the last day of the month next succeeding the quarterly period). The Department also determined that the requirements for distributors to report the excise taxes collected on cannabis transactions should be consistent with the requirements to report the same cannabis transactions for sales and use tax purposes. Therefore, the Department determined that it is necessary for Regulation 3700 to specify that a distributor shall report and remit the cannabis excise tax due with the return for the quarterly period in which the distributor sells or transfers the cannabis or cannabis products to a cannabis retailer.

Regulation 3700, Subdivision (f)

RTC section 34013, subdivision (e), provides that any person required to be licensed pursuant to MAUCRSA who fails to pay the cannabis excise tax or the cultivation tax shall be subject to a penalty of at least one-half the amount of the taxes not paid. The written comment sent on behalf of the CCIA dated August 24, 2017, indicated that the CCIA believed the penalty was discretionary and should only apply when a taxpayer knowingly fails to pay the cannabis taxes. The Department has determined that the penalty is mandatory due to the statute's use of the word "shall." However, RTC section 55044 authorizes the Department to relieve a person of the penalty if the Department finds that the person's failure to make a timely payment is due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect.

Also, the FCPL applies to the administration and collection of the cannabis taxes (RTC, § 34013, subd. (a)), and the FCPL provides for the imposition of a 10 percent penalty on cannabis taxes that are reported, but not paid within the time required (RTC, § 55042), and a 10 percent penalty on deficiency determinations issued for cannabis taxes that are either underreported or not reported if the taxes are not paid when the deficiency determinations become final and the taxes are due and payable. (RTC, § 55086.) The Department understands that the penalty imposed by RTC section 34013, subdivision (e), is substantial in relation to other penalties imposed by the RTC solely for the failure to pay a tax or fee when due (see, e.g., RTC, § 6591, which imposes a 10% penalty for the failure to timely pay sales and use taxes, in addition to RTC, §§ 55042, 55086), and the penalty imposed by RTC section 34013, subdivision (e), is in addition to the penalties imposed under the FCPL. And, the Department understands that the emerging cannabis industry may face significant obstacles related to the payment of the cannabis taxes, and payments may be delayed despite a taxpayer's good faith efforts because of the lack of banking services, limited facilities that accept cash payments, and the remoteness of some commercial cannabis operations.

Therefore, the Department determined that it is necessary for Regulation 3700 to clarify that the penalty imposed by RTC section 34013, subdivision (e), is mandatory. It is necessary for Regulation 3700 to set the penalty at "fifty percent of the amount of the unpaid cannabis excise tax or cannabis cultivation tax," so the penalty is at least one-half of the amount of the taxes, as required by the statute, but not more than one-half of the amount of the taxes. And, it is necessary for Regulation 3700 to incorporate and duplicate the provisions of RTC section 55044, subdivision (a), which authorize the Department to relieve the penalty under specified circumstances, and the provisions of RTC section 55044, subdivision (b), which provide that "any person seeking to be relieved of the penalty shall file with the department a statement, under penalty of perjury, setting forth the facts upon which he or she bases his or her claim for relief."

DOCUMENTS RELIED UPON

The Department relied on its formal issue paper regarding proposed emergency Regulation 3700 dated October 25, 2017, and the exhibits to the issue paper, including the written comments referred to above, in deciding that the adoption of proposed emergency Regulation 3700 is necessary to have the effect and accomplish the objective of addressing all the critical issues with

the CTL discussed above before the cannabis excise and cultivation taxes are effective January 1, 2018.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Department has determined that the adoption of proposed emergency Regulation 3700 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the GC.

ONE-TIME COST TO THE DEPARTMENT, BUT NO OTHER COST OR SAVINGS TO ANY STATE AGENCY, LOCAL AGENCY, OR SCHOOL DISTRICT

The Department has determined that the adoption of proposed emergency Regulation 3700 will result in an absorbable \$396 one-time cost for the Department to update its website after the emergency rulemaking process is completed (assuming that average hourly compensation costs are \$49.48 per hour and that it will take approximately eight hours). The Department has determined that the adoption of proposed emergency Regulation 3700 will result in no other direct or indirect cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the GC, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

EFFECTIVE PERIOD

RTC section 34013, subdivision (d), provides that the emergency regulations adopted by the Department may remain in effect for two years from adoption. Therefore, Regulation 3700 shall be effective immediately upon filing with the Secretary of State and shall remain in effect for two years from that date, unless the Department amends or repeals it before the expiration of the two-year period.

STATUTORY EXEMPTION FOR REGULATIONS THAT ESTABLISH OR FIX RATES

Regulation 3700, subdivision (c)(3), establishes the rates of the cannabis cultivation tax. The establishment of rates is exempt from the requirements of chapter 3.5 of part 1 of division 3 of title 2 of the GC by GC section 11340.9, subdivision (g).

CONTACT PERSONS

Questions regarding the substance of Regulation 3700 should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at Bradley.Heller@cdtfa.ca.gov, or by mail at California Department of Tax and Fee Administration, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Other inquiries concerning the emergency regulation should be directed to Robert Wilke, Program Policy Specialist, by telephone at 916-445-2137 or by email at BTfD-

BTC.InformationRequests@cdtfa.ca.gov. Mr. Wilke is the designated backup contact person to Mr. Heller.

TEXT OF EMERGENCY REGULATION 3700

(New chapter and regulation to be added to Cal. Code Regs., tit. 18, div. 2)

Chapter 8.7. Cannabis Tax Regulations

Regulation 3700. Cannabis Excise and Cultivation Taxes.

(a) Definitions. For purposes of this chapter (Cannabis Tax Regulations, commencing with Regulation 3700), the definitions of terms in part 14.5, Cannabis Tax, (commencing with section 34010) of division 2 of the Revenue and Taxation Code shall apply and the following terms are defined or further defined below.

(1) “Cannabis flowers” means the flowers of the plant *Cannabis sativa* L. that have been harvested, dried, and cured, and prior to any processing whereby the plant material is transformed into a concentrate, including, but not limited to, concentrated cannabis, or an edible or topical product containing cannabis or concentrated cannabis and other ingredients. The term “cannabis flowers” excludes leaves and stems.

(2) “Cannabis leaves” means all parts of the plant *Cannabis sativa* L. other than cannabis flowers that are sold or consumed.

(3) “Cultivator” means all persons required to be licensed to cultivate cannabis pursuant to division 10 (commencing with section 26000) of the Business and Professions Code, including a microbusiness that cultivates cannabis as set forth in paragraph (3) of subdivision (a) of section 26070 of the Business and Professions Code.

(4) “Distributor” means a person required to be licensed as a distributor pursuant to division 10 (commencing with section 26000) of the Business and Professions, including a microbusiness that acts as a licensed distributor as set forth in paragraph (3) of subdivision (a) of section 26070 of the Business and Professions Code.

(5) “Fresh cannabis plant” means the flowers, leaves, or a combination of adjoined flowers, leaves, stems, and stalk from the plant *Cannabis sativa* L. that is either cut off just above the roots, or otherwise removed from the plant.

To be considered “fresh cannabis plant,” the flowers, leaves, or combination of adjoined flowers, leaves, stems, and stalk must be weighed within two hours of the plant being harvested and without any further processing, including any artificial drying such as increasing the ambient temperature of the room or any other form of drying, curing, or trimming.

(6) “Manufacturer” means a person required to be licensed as a manufacturer pursuant to division 10 (commencing with section 26000) of the Business and Professions Code,

including a microbusiness that acts as a licensed manufacturer as set forth in paragraph (3) of subdivision (a) of section 26070 of the Business and Professions Code.

(7) “Ounce” means 28.35 grams.

(8) “Plant waste” means waste of the plant *Cannabis sativa* L. that is not hazardous waste, as defined in section 40141 of the Public Resources Code, and is solid waste, as defined in section 40191 of the Public Resources Code, that has been made unusable and unrecognizable. For the purpose of this subdivision, plant waste is deemed “unusable and unrecognizable” when it is ground and incorporated with other ground material so that the resulting mixture is at least fifty percent non cannabis material by volume.

(9) “Wholesale cost” means the amount paid by the retailer for the cannabis or cannabis product, including transportation charges. Discounts and trade allowances must be added back when determining wholesale cost.

For purposes of this subdivision, “discounts or trade allowances” are price reductions, or allowances of any kind, whether stated or unstated, and include, without limitation, any price reduction applied to a supplier’s price list. The discounts may be for prompt payment, payment in cash, bulk purchases, related-party transactions, or “preferred-customer” status.

(b) Collection of Cultivation Tax When Testing Requirement is Waived. For purposes of the cultivation tax imposed on all harvested cannabis that enters the commercial market pursuant to section 34012 of the Revenue and Taxation Code, when the testing requirement is waived pursuant to subdivision (l) of section 26070 of the Business and Professions Code, a distributor shall collect the cultivation tax from cultivators when cannabis is transferred or sold to the distributor.

(c) Cultivation Tax Rates. For transactions made on and after January 1, 2018, the rate of the cultivation tax is as follows:

(1) Nine dollars and twenty-five cents (\$9.25) per dry-weight ounce of cannabis flowers, and at a proportionate rate for any other quantity.

(2) Two dollars and seventy-five cents (\$2.75) per dry-weight ounce of cannabis leaves, and at a proportionate rate for any other quantity.

(3) One dollar and twenty-nine cents (\$1.29) per ounce of fresh cannabis plant, and at a proportionate rate for any other quantity.

(d) Cannabis Removed from a Cultivator’s Premises is Presumed Sold.

(1) Unless the contrary is established, it shall be presumed that all cannabis removed from the cultivator’s premises, except for plant waste, is sold and thereby taxable pursuant to section 34012 of the Revenue and Taxation Code.

(2) The presumption in subdivision (d)(1) may be rebutted by a preponderance of the evidence demonstrating that the cannabis was removed for purposes other than for entry into the commercial market. Reasons for which cannabis may be removed and not subject to tax on that removal include, but are not limited to, the following:

(A) Fire,

(B) Flood,

(C) Pest control,

(D) Processing,

(E) Storage prior to the completion of, and compliance with, the quality assurance review and testing, as required by Business and Professions Code section 26110, and

(F) Testing.

(e) Reporting the Cannabis Excise Tax. A distributor shall report and remit the cannabis excise tax due with the return for the quarterly period in which the distributor sells or transfers the cannabis or cannabis products to a cannabis retailer.

(f) Penalties.

(1) Late Payments. In addition to any other penalty imposed pursuant to the Fee Collection Procedures Law (commencing with section 55001 of the Revenue and Taxation Code) or any other penalty provided by law, a penalty of 50 percent of the amount of the unpaid cannabis excise tax or cannabis cultivation tax shall be added to the cannabis excise tax and cultivation tax not paid in whole or in part within the time required pursuant to sections 34015 and 55041.1 of the Revenue and Taxation Code.

(2) Relief from Late Payment Penalty for Reasonable Cause. If the Department finds that a person's failure to make a timely payment is due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect, the person may be relieved of the penalty provided by subdivision (f)(1) for such failure.

Any person seeking to be relieved of the penalty shall file with the Department a statement under penalty of perjury setting forth the facts upon which the claim for relief is based.

Note: Authority cited: Sections 34013, Revenue and Taxation Code. Reference: Sections 34010, 34011, 34012, 34013, 34015, and 55044 Revenue and Taxation Code.